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IN THE

Supreme Court of the United States

October Term, 1970

No. 1677

UNION PACIFIC RAILROAD COMPANY,

Petitioner,

v.

UNITED STATES OF AMERICA,

Respondent.

PETITION FOR A WRIT OF CERTIORARI TO THE UNITED STATES COURT OF CLAIMS

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UNION PACIFIC RAILROAD COMPANY,

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v.

UNITED STATES OF AMERICA,

Respondent.

PETITION FOR A WRIT OF CERTIORARI TO THE UNITED STATES COURT OF CLAIMS

Union Pacific Railroad Company prays that a writ of certiorari issue to review the Order of the United States Court of Claims denying petitioner's motion for rehearing or reconsideration.

Order Below

The Order of the United States Court of Claims is unpublished, and is reprinted in Appendix A, *infra*, p. 10.

Jurisdiction

The Order of the United States Court of Claims was entered on February 5, 1971. The jurisdiction of this Court is invoked under 28 U.S.C. § 1255(1).

Question Presented

Whether, under the provisions of the World War II Excess Profits Tax Act, the amount includible in petitioner's equity invested capital, for purposes of computing its excess profits tax credit, upon the issuance by petitioner of its common stock in exchange for, and upon conversion of certain of its bonds, is to be determined by the value of such shares at the time of their issuance in exchange for such bonds, and not by the amount received upon the original sale of the bonds.

Statutes and Regulations Involved

The pertinent portions of the statutes and regulations involved are as follows:

Internal Revenue Code of 1939:

SEC. 113. ADJUSTED BASIS FOR DETERMINING GAIN OR LOSS.

(a) *Basis (Unadjusted) of Property.*—The basis of property shall be the cost of such property; * * *

(26 U.S.C. 1952 ed., Sec. 113.)

SEC. 718 [as added by Sec. 201, Second Revenue Act of 1940, c. 757, 54 Stat. 974, and amended by Sec. 218, Revenue Act of 1942, c. 619, 56 Stat. 798].

EQUITY INVESTED CAPITAL.

(a) *Definition.*—The equity invested capital for any day of any taxable year shall be determined as of the beginning of such day and shall be the sum of the following amounts, reduced as provided in subsection (b)—

(1) *Money paid in.*—Money previously paid in for stock, or as paid-in surplus, or as a contribution to capital;

(2) *Property paid in.*—Property (other than money) previously paid in (regardless of the time paid in) for stock, or as paid-in surplus, or as a contribution to capital. Such property shall be included in an amount equal to its basis (unadjusted) for determining loss upon sale or exchange. If the property was disposed of before such taxable year, such basis shall be determined under the law applicable to the year of disposition, but without regard to the value of the property as of March 1, 1913. If the property was disposed of before March 1, 1913, its basis shall be considered to be its fair market value at the time paid in. If the unadjusted basis of the property is a substituted basis, such basis shall be adjusted, with respect to the period before the property was paid in, by an amount equal to the adjustments proper under section 115(l) for determining earnings and profits;

* * *

(26 U.S.C. 1952 ed., Sec. 718.)

Treasury Regulations:

REGULATIONS 112, SECTION 35.718-1.

DETERMINATION OF DAILY EQUITY INVESTED CAPITAL—MONEY AND PROPERTY PAID IN.—The equity invested capital for any day is determined as of the beginning of such day. The basis or starting point is found in the amount of money and property previously paid in for stock, or as paid-in surplus, or as a contribution to capital. The terms "money paid in" and "property paid in" do not include amounts received as premiums by an insurance company subject to taxation under section 204. For the purpose of determining equity invested capital, the amount of any property paid in is the unadjusted basis to the taxpayer for determining loss upon a sale or exchange under the law applicable to the taxable year for which the invested capital is being computed. If

the property was disposed of after February 28, 1913, and before such taxable year, such unadjusted basis shall be determined under the law applicable to the year of disposition, but without regard to the value of the property as of March 1, 1913; if the property was disposed of before March 1, 1913, its unadjusted basis shall be considered to be its fair market value at the time paid in.

If the basis to the taxpayer is cost and stock was issued for the property, the cost is the fair market value of such stock at the time of its issuance. If the stock had no established market value at the time of the exchange, the fair market value of the assets of the company at that time should be determined and the liabilities deducted. The resulting net worth will be deemed to represent the total value of the outstanding stock. In determining net worth for the purpose of fixing the fair market value of the stock at the time of the exchange, the property paid in for such stock shall be included in the assets at its fair market value at that time.

If stock having no established market value is issued for intangible property, and it is necessary to determine the fair market value of such property, the following factors, among others, may be taken into consideration in determining such value: (a) The earnings attributable to such intangible assets while in the hands of the predecessor owner; and (b) any cash offers for the purchase of the business, including the intangible property, at or about the time of its acquisition. A corporation claiming a value for intangible property paid in for stock should file with its return a full statement of the facts relating to such valuation.

* * *

(26 C.F.R., Part 35, Section 718 (1943 Supplement).)

Statement of the Case

In 1901, petitioner issued $100 million in ten-year four percent bonds which were convertible at the option of the holder into $100 par value common stock. Petitioner re-

ceived cash in the face amount of said bonds on issuance. During the years 1901 through 1907, petitioner issued 994,500 shares of its common stock on conversion of $99,450,000 principal amount of these bonds.

In 1907, petitioner issued $73,762,000 in twenty-year four percent bonds which were convertible at the option of the holder into $100 par value common stock at the rate of one share of stock for each $175 face value of bonds. Petitioner received cash in the face amount of said bonds on issuance. During the years 1908 through 1914, petitioner issued 268,153 shares of its common stock on conversion of $46,926,775 principal amount of these bonds.

At the times of conversion of the bonds of both issues, the fair market value of the stock issued and the fair market value of the bonds greatly exceeded the par value of said stock and the face amount of said bonds.

Before the Court of Claims, petitioner asserted that, in computing its equity invested capital, it should have included the fair market value of said stock in money or property paid in for stock and claimed an additional $106,375,300, the difference between the fair market value of the shares when issued and their par value. Only par value of the shares had been allowed by the Commissioner.

In an opinion dated October 18, 1968 (Appendix B, *infra*, pp. 11-25; 401 F. 2d 778) the Court of Claims ruled in respondent's favor, holding that in determining the amount paid in to and received by a corporation upon the conversion of its bonds to stock, the value of the securities at the time of conversion is immaterial, rather the paid-in capital received is to be limited to the amount originally paid in for the bonds. Certiorari was denied by this Court on June 9, 1969 (395 U.S. 944).

On November 13, 1970, the Court of Claims, in *Missouri Pacific Railroad Company* v. *The United States of America* (Appendix C, *infra*, pp. 26-30), held that in determining

the amount paid in to and received by a corporation upon the issuance of its bonds for securities, the amount originally paid in for the securities must be disregarded, the measure being the value of the securities at the time they are paid in when such value is in excess of the amount originally received (433 F. 2d 1324).

On December 10, 1970, petitioner filed a motion in the Court of Claims for leave to file a motion for rehearing or reconsideration of that Court's opinion in the *Union Pacific* proceeding, *supra,* in light of that Court's decision in *Missouri Pacific, supra,* urging that the *Missouri Pacific* decision adopted and applied legal principles and reasonings which were diametrically opposed to the legal principles and reasonings set down by that Court in *Union Pacific.* Petitioner's motion was denied on February 5, 1971.

Missouri Pacific's petition for certiorari was denied by this Court on May 3, 1971 (Docket Number 1333, October Term, 1970).

Reasons For Granting The Writ

1. The reasoning of the Court of Claims in *Missouri Pacific* constitutes a new development in the law which is equally applicable to, and should be applied in the *Union Pacific* proceeding.

By its *per curiam* opinion of November 13, 1970, the Court of Claims in *Missouri Pacific* adopted and applied legal principles and reasonings governing the determination of what is paid in to a corporation which are diametrically opposed to the legal principles and reasonings upon which that Court relied in *Union Pacific.*

In *Union Pacific* the Court below held that where a corporation issues its stock in exchange for and in conversion of its bonds, the only amount which can be deemed

to have been paid in to and received by the corporation is the amount originally paid for the bonds because the subsequent exchange upon conversion constitutes nothing more than a "paper transaction".

On the other hand, in *Missouri Pacific,* the Court below held that where a corporation issues its bonds in exchange for its securities, the amount deemed to have been paid in to and received by the corporation must be determined by reference to the value of the securities *at the time of the exchange;* the amount originally paid in for the bonds being merely the minimum amount which the corporation received.

Moreover, the Court below has recognized that the legal criteria for determining the amount paid in to a corporation for invested capital or debt discount purposes are precisely the same. (See *Erie Lackawanna Railroad Company* v. *United States,* 422 F. 2d 425 (1970), a debt discount case wherein the Court of Claims relied upon its prior decision in *Union Pacific, supra;* and *Missouri Pacific Railroad* v. *United States,* 427 F. 2d 727 (1970), another debt discount case wherein that Court relied upon both *Union Pacific* and *Erie Lackawanna, supra.*)

Finally, the Court below in its November 13, 1970 *per curiam* decision in *Missouri Pacific* took cognizance of the fact that it was adopting new criteria when it cited the decision of the United States District Court for the Southern District of New York in *Cities Service Co.* v. *United States,* 316 F. Supp. 61, which it noted was "contrary to our original opinion in this case". Relying on *Cities Service* the Court held, at 433 F. 2d 1325-1326:

> On reconsideration, persuaded by this *Cities Service* discussion, we hold that, with respect to shares of its own stock or stock in its subsidiaries, the present taxpayer cannot calculate, for debt discount purposes, the value of the stock at its cost or issuance price. That figure can be the floor but it cannot be the ceiling. The correct measure is the

> value of the New Orleans stock to plaintiff *at the time of the exchange* of the bonds for that stock. (Emphasis supplied.)

Petitioner submits that the principles thus adopted by the Court of Claims in *Missouri Pacific* have equal application to the *Union Pacific* proceeding, and thus the Court of Claims was in error when it refused to apply them upon petitioner's motion for rehearing or reconsideration.

2. Substantial justice requires that the law be applied equally to similarly situated taxpayers, a result which has not been achieved in the instant proceeding.

Essentially, the Court below has denied relief to two similarly situated taxpayers. In the first instance, relief was denied to Union Pacific on the grounds that the amount originally paid in to it upon issuance of its convertible bonds constituted both the "floor" and the "ceiling" for purposes of determining its paid-in capital, its subsequent issuance of stock in exchange for and in conversion of such bonds being nothing more than a "paper transaction". In the second instance, relief was denied to Missouri Pacific on the grounds that, while the amount originally paid in to it upon its first issuance of securities constituted the "floor" for purposes of determining its paid-in capital, the "ceiling" was the amount received by it upon its issuance of bonds for such securities.

Both parties sought redress before the Court of Claims on motions for reconsideration, contending that the legal reasonings adopted by that Court in the two proceedings were inconsistent with one another. That Court refused to acknowledge the inconsistency.

In the posture of the instant proceeding, this Court's denial of the Missouri Pacific petition for certiorari carries with it more than the usual lack of inference. Petitioner

respectfully submits that in light of the action of the Court below, as well as this Court's recent denial of certiorari in *Missouri Pacific,* the Court of Claims' decision in *Union Pacific* is no longer a viable one, and, in view of the more recent development of the law, should be reversed.

Conclusion

WHEREFORE, it is prayed that, for the foregoing reasons, this petition for writ of certiorari should be granted.

Respectfully submitted,

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APPENDIX A

IN THE

United States Court of Claims

No. 310-62

(Filed February 5, 1971)

—o—

UNION PACIFIC RAILROAD COMPANY

v.

THE UNITED STATES

—o—

Before:

COWEN, *Chief Judge,*
LARAMORE, DURFEE, DAVIS, COLLINS, SKELTON and NICHOLS, *Judges.*

ORDER

This case comes before the court on plaintiff's motion, filed December 10, 1970, for leave to file motion for rehearing or reconsideration. Upon consideration thereof, together with the opposition thereto, without oral argument, it is enough to point out, among the several significant distinctions of this case from *Missouri Pacific R.R.* v. *United States,* Nos. 142-67 and 95-68, that in its opinion in this case the court specifically indicated that, for the purposes of the excess profits tax, Congress did not desire to include unrealized appreciation in value in equity invested capital. See 185 Ct. Cl. 393, 402-404.

IT IS THEREFORE ORDERED that plaintiff's said motion for leave to file motion for rehearing or reconsideration be and the same is denied.

BY THE COURT

Chief Judge

APPENDIX B

IN THE

UNITED STATES COURT OF CLAIMS

No. 310-62

(Decided October 18, 1968)

UNION PACIFIC RAILROAD COMPANY

v.

THE UNITED STATES

ROBERT J. CASEY, attorney of record, for plaintiff. THOMAS E. TYRE, JOHN A. CRAIG, THOMAS J. MCCOY, JR. and CLARK, CARR & ELLIS, of counsel.

THEODORE D. PEYSER, with whom was ASSISTANT ATTORNEY GENERAL MITCHELL ROGOVIN, for defendant. PHILIP R. MILLER and JOSEPH KOVNER, of counsel.

Before COWEN, *Chief Judge,* LARAMORE, DURFEE, DAVIS, SKELTON, and NICHOLS, *Judges.*

ON PLAINTIFF'S AND DEFENDANT'S MOTIONS FOR PARTIAL SUMMARY JUDGMENT

SKELTON, *Judge,* delivered the opinion of the court:

The plaintiff, Union Pacific Railroad Company, was and has been at all times pertinent hereto, a corporation organ-

ized and existing under the laws of the State of Utah, with its office and principal place of business in New York. It brought this action to recover, among other items, $4,187,-159.68 in income and excess profits tax and assessed interest thereon paid for the calendar year 1942, together with statutory interest thereon, and $9,222,801.78 in statutory interest on refunds or credits of tax previously made for 1942.

Both plaintiff and defendant (The United States of America) have moved for partial summary judgment with reference to the claims set forth in Counts XXIX and XXX of plaintiff's first amended petition. The consideration and disposition of these motions is all that is before the court for decision at this time.

In our opinion decided January 19, 1968, we held that this court had jurisdiction over the issues embraced in these two counts solely as offsets to the defendant's offsets.[1] These issues involve the problem of what should be included in plaintiff's equity invested capital for purposes of determining its excess profits tax credit under the provisions of the World War II Excess Profits Tax Act. It naturally follows that the greater plaintiff's equity invested capital, the more credit it will receive and the less taxes it will have to pay. Under these circumstances, it is to plaintiff's advantage to show as large an amount of equity invested capital as possible. It seeks to do this by the following facts set forth in Counts XXIX and XXX of its amended petition.

In Count XXIX, it is shown that in 1901, plaintiff issued $100 million in ten-year four percent bonds convertible at the option of the holder into $100 par value common stock. The bonds could be converted into or exchanged for stock on the basis of one share of the $100 par value common

---

[1] *Union Pacific Railroad Co.* v. *United States*, 182 Ct. Cl. 103, 389 F. 2d 437 (1968). See that decision for an over-all statement of plaintiff's entire case, which will not be repeated here.

stock for each $100 principal amount of the bonds. The plaintiff received $100 million in cash for these bonds. From 1901 through 1907, holders of the bonds converted $99,450,000 principal amount of the bonds into 994,500 shares of plaintiff's common stock which plaintiff issued to them on the basis specified in the bonds when they were originally issued (*i.e.*, $100 par value share of stock for each $100 amount of bonds). The plaintiff computed its excess profits tax credit based on equity invested capital for the year 1942 and its unused excess profits carryovers from 1940 and 1941 by including in money and property paid in for the issuance of the 994,500 shares of stock, the sum of $99,450,000. This was approved by the Commissioner of Internal Revenue. However, in its first amended petition, filed herein December 14, 1966, plaintiff claims for the first time that the Commisisoner, in computing plaintiff's excess profits tax credit based on equity invested capital, should have included in money and property paid in for stock an additional $28,662,393.68, which is alleged to be the excess of the fair market value of said stock over its par value at the time the bonds were converted into stock.

In Count XXX, plaintiff alleges that in 1907 it issued $73,762,000 in twenty-year four percent bonds convertible at the option of the holder into $100 par value common stock at the rate of one share of stock for $175 face value in bonds. The plaintiff received $73,762,000 in cash for these bonds. During the years 1908 through 1914, the holders of $46,926,775 principal amount of the bonds converted them into 268,153 shares of common stock which were issued to them by the plaintiff for the bonds. (The sum of $46,926,775, divided by the conversion rate of $175, equals the 268,153 shares of stock so issued.) The plaintiff computed its excess profits credit based on equity invested capital for the year 1942 and its unused excess profits carryovers from 1940 and 1941 by including in equity invested capital $175 for each of the 268,153 shares of stock in the total sum of $46,926,775.

This was approved by the Commissioner of Internal Revenue.

When plaintiff filed its first amended original petition on December 14, 1966, it claimed for the first time in Count XXX that the Commissioner should have increased plaintiff's money and property paid in for stock, in computing its excess profits tax credit based on equity invested capital for the year 1942, and in computing its unused profits tax credit carryovers from 1940 and 1941 by the excess of the fair market value of the stock so issued over its par value in the total sum of $19,403,421.

In short, the problem before us in the motions is to determine the amount of money or property that was paid in on account of the issuance of the 1,262,653 shares of common stock from 1901 through 1914 by the conversion of the two types of taxpayer's convertible bonds. We might point out that the differences in the two types of bonds are immaterial, because the same principles are involved as to both. We shall, accordingly, treat them for all practical purposes as if they were one type or one issue.

The plaintiff contends that it is entitled to include in its equity invested capital for the purpose of determining its excess profits tax credit under the World War II Excess Profits Tax Act, ch. 757, § 201, 54 Stat. 974 (1940), the fair market value of its stock issued in exchange for, and upon conversion of, the bonds issued by it. In the alternative, plaintiff says it is entitled to include in its equity invested capital the fair market value of the bonds converted as of the time of the conversion, and, in the further alternative, their cost to the transferors, who were the last holders of the bonds.

On the other hand, the government contends that the amount to be included in the plaintiff's equity invested capital is the cash paid to the plaintiff at the time the bonds were originally issued and sold. It argues that the

conversion did not add anything to or subtract anything from plaintiff's assets, but it merely substituted a stock liability for a debt. It points out that the taxpayer acquired nothing but the converted bonds when it issued the stock and surrendered nothing but the stock, which was issued at the ratio prescribed in the bonds. The bonds were immediately canceled when plaintiff received them. Defendant says that the value of the bonds and the stock at the time of the conversion is immaterial, because the money paid in for the bonds at the time they were originally issued was the money and property paid in for equity invested capital purposes and nothing more was paid in at the time of the conversion. Both parties agree that the bonds and the stock were of approximately the same value at the time of the conversion. However, both had increased in value many times since the bonds were first issued.

This is a case of first impression on the problem before us. No case has been cited to us, and we have found none, that involves the precise question to be decided here.

The plaintiff bases its case primarily on Section 718(a) of the 1939 Code of Internal Revenue, which is as follows:

> Sec. 718 [as added by Sec. 201, Second Revenue Act of 1940, 54 Stat. 982, and amended by Sec. 218, Revenue Act of 1942, c. 619, 56 Stat. 798]. Equity Invested Capital.
>
> (a) *Definition.*—The equity invested capital for any day of any taxable year shall be determined as of the beginning of such day and shall be the sum of the following amounts, reduced as provided in subsection (b)—
>
> (1) *Money paid in.*—Money previously paid in for stock, or as paid-in surplus, or as a contribution to capital;
>
> (2) *Property paid in.*—Property (other than money) previously paid in (regardless of the time paid in) for stock, or as paid-in surplus, or as a

> contribution to capital. Such property shall be included in an amount equal to its basis (unadjusted) for determining loss upon sale or exchange. If the property was disposed of before such taxable year, such basis shall be determined under the law applicable to the year of disposition, but without regard to the value of the property as of March 1, 1913. If the property was disposed of before March 1, 1913, its basis shall be considered to be its fair market value at the time paid in. If the unadjusted basis of the property is a substituted basis, such basis shall be adjusted, with respect to the period before the property was paid in, by an amount equal to the adjustments proper under section 115(l) for determining earnings and profits;[2]
>
> * * *

The plaintiff also relies on the following portion of Treasury Regulation 112, Section 35.718-1, which relates to the above-quoted Section 718 of the 1939 Code:

> If the basis to the taxpayer is cost and stock was issued for the property, the cost is the fair market value of such stock at the time of its issuance.[3]

The 1939 Code provides that all provisions of law applicable in respect of the taxes imposed by Chapter 1 of such Code shall be applicable in respect of the tax imposed by Subchapter E (Excess Profits Tax).[4]

Plaintiff contends that for the taxable year 1942 involved here, its basis for loss (unadjusted) is to be determined under Section 113 of the Revenue Code of 1939, which provides:

> Sec. 113. Adjusted basis for determining gain or loss.

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[2] 26 U.S.C. 1952 ed., Section 718.
[3] 26 C.F.R., Part 35, Section 718 (1943 Cum. Supp.).
[4] 26 U.S.C. 1952 ed., Sections 728 and 729.

> (a) *Basis (unadjusted) of property.*—The basis of property shall be the cost of such property; * * *[5]

Accordingly, plaintiff first submits that the basis of the property paid in to it is its cost, namely, the fair market value of the stock issued as consideration for the property received at the time of the conversion. It says that Section 718(a) of the 1939 Code quoted above, defines equity invested capital as (1) "Money" paid in, or (2) "Property other than money" paid in. It argues that at the time of the conversion no money was paid in for the stock, but on the other hand, bonds were paid in for it. It contends that "for the purposes of determining equity invested capital, the bonds must be considered property." It reasons that Treasury Regulations 112, Section 35.718-1, *supra,* provide that the fair market value of the stock at the time of its issuance controls and that such value represents the cost basis of the taxpayer for the bonds it received in exchange for the stock, which basis should be added to its equity invested capital.

We do not agree with plaintiff's application of the provisions of the Internal Revenue Code and the Treasury Regulations to the facts of this case. The plaintiff has made an ingenious argument based on a literal reading of Section 718(a), *supra*, that equity invested capital is either money, or property other than money paid in for stock, and that the bonds were property and not money which were paid in for stock at the time of the conversion. From this, it reasons that according to the Treasury Regulations, its cost basis for the bonds at the time of the conversion was the fair market value of the stock it issued for the bonds. We do not agree that this case can be disposed of by a mere literal reading of the statute and the reulations. It is necessary to go back to the beginning of the transaction and consider all of the facts from

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[5] 26 U.S.C. 1952 ed., Section 113.

that time up to and including the conversion of the bonds for the stock and look at the case from its four corners. The plaintiff would have us consider only what happened at the time of the conversion as if the exchange of the bonds for the stock was a new and independent act with no connection with what had transpired before. This we cannot do, as "the tail must go with the hide." As a matter of fact, the relationship, rights and obligations of the taxpayer and the bondholders were established when the convertible bonds were issued by the taxpayer in consideration of the cash paid to it by the purchasers of the bonds. The bonds provided that a designated amount of the bonds could be exchanged or converted within a stated period of time by the holders thereof for a fixed amount of stock of the taxpayer. By this means, the values of the bonds and the stock were definitely fixed with relation to each other, and it made no difference in later years whether either or both increased, decreased, or remained unchanged as to fair market value, because the bondholders could always exchange or convert the same amount of stock, regardless of the market value of either or both. The taxpayer was always obligated to issue stock for the bonds at the ratio provided for in the bonds when requested to do so by the bondholders, and could not take any advantage of a fluctuation in the market value of the stock or of the bonds or of both. So, for all practical purposes, the market value of the stock and of the bonds at the time of the conversion was immaterial. The cost of the stock to the bondholders in relation to the bonds had been fixed from the time the bonds were issued and this cost never changed. When the bondholders bought the bonds, they paid cash for them. It was agreed that if the bonds were ever converted into stock, no additional money or payment was to be required of the bondholders. Therefore, for all practical purposes, the original payment of money for the bonds when they were issued became money paid in for stock when the bonds were converted into stock, and such money became a part of the equity invested capital of the plaintiff. This is

true as a matter of fact as well as under the provisions of Section 718(a) of the 1939 Code, *supra*.

We agree with defendant that the only money or property paid in for taxpayer's stock was the money originally paid by the purchasers of the bonds. Upon conversion, no additional money or property was paid to the taxpayer for its stock. The taxpayer further argues that the bonds were property and cites *Victory Glass, Inc.* v. *C.I.R.*, 11 T.C. 656 (1948); *Difco Laboratories, Inc.* v. *C.I.R.*, 10 T.C. 660 (1948); and *Walsh Holyoke Steam Boiler Works, Inc.* v. *C.I.R.*, 160 F. 2d 185 (C.A. 1st, 1947) as authority for this proposition (that bonds and notes are property), and also for the further proposition that their value at the time they were exchanged for stock should be included in equity invested capital. These cases are of no help to plaintiff because none of them involved convertible bonds. It is true as a general proposition that bonds are property, but here the bonds were debts of the taxpayer. Of course, if a taxpayer exchanges its stock for bonds of another company that are not convertible debts of the taxpayer, the above cases would lend support to the taxpayer's argument that the bonds are property and their value at the time of the exchange determines the amount to be included in taxpayer's equity invested capital. But that is not the situation here. In this case, upon the conversion, the taxpayer merely substituted stock liability for a bonded indebtedness. This added nothing to its equity invested capital. We do not agree with taxpayer's alternative argument that it is entitled to include in its equity invested capital the fair market value of the bonds at the time of the conversion.

The plaintiff argues further that by the conversion of the bonds for the stock, the bondholders contributed additional *going concern value* which plaintiff paid for by the issuance of stock therefor and which became an asset of the corporation, and, therefore, should be included in its equity invested capital, although it is an intangible. We

hold that Congress never intended this kind of a result in enacting Section 718(a) of the 1939 Code. If the taxpayer corporation had any going concern value, it possessed it before the conversion of the bonds for stock was effected and the conversion had nothing to do with it. To allow plaintiff to add to its equity invested capital by the payment of its bonded indebtedness on the theory that on such payment the creditor-bondholder contributed going concern value to the taxpayer which became a part of such capital, would be to allow it to include in such capital unrealized appreciation of its assets. This is not permissible. *LaBelle Iron Works* v. *United States,* 256 U.S. 377 (1921).

When the conversion took place, the plaintiff received nothing but the bonds, which it canceled, and gave up nothing but the stock. The conversion added nothing and subtracted nothing from its assets. The effect and result of the entire transaction was that the money originally paid in for the bonds was the money and property paid in for the stock, and this money was all that was added or could be added to taxpayer's equity invested capital. The taxpayer so treated the transaction in its tax returns from 1901 until the filing of its amended petition in this court in 1966, with the approval of the Commissioner of Internal Revenue.

Equity invested capital is limited to funds and property actually invested in the taxpayer's business. Unrealized appreciation of its assets (or losses) cannot form a part of such capital. This was the holding of *LaBelle Iron Works* v. *United States, supra.* That was a case involving invested capital and excess profits tax during the First World War. There the taxpayer increased the value of some of its assets by $10 million, which it carried to surplus, and it then declared a stock dividend by issuing $19.8 million of stock for $9.9 million of its old stock on a par value basis. The court held that such a transaction was in effect a "paper transaction" which did not increase the invested capital

of the company since it did not add any new capital to it. In deciding the *LaBelle* case, the Supreme Court explained that the purpose of the World War I Excess Profits Tax, Revenue Act of 1917, ch. 63, 8207, 40 Stat. 300, was to raise money quickly for the war effort, and it noted the reasons Congress chose the language that it did.

> * * * [i]t was the dominant purpose of Congress to place the peculiar burden of this tax upon the income of * * * businesses exceeding what was deemed a normally reasonable return upon the capital actually embarked. But if such capital were to be computed according to appreciated market values based upon the estimates of interested parties (on whose returns perforce the Government must in great part rely), exaggerations would be at a premium, corrections difficult, and the tax easily evaded. *LaBelle, supra,* at 387.

Thus, to avoid a practically impossible administrative burden of determining inflated market values and to prevent avoidance of the tax, "the draftsman of the act resorted to the test of including nothing but money, or money's worth, actually contributed * * *." *Id.* at 388

In light of this World War I Act and the *LaBelle* decision, Section 718, *supra,* was adopted. The problems of determining inflated values and the desire to prevent avoidance of the tax were as great when this section was adopted as in 1917, and again Congress chose a restricted definition of "invested capital." If anything, contrary to plaintiff's argument that Section 718 is less restrictive than the World War I Act, the World War II Act definition narrowed the scope of the earlier definition. Section 207 of the Revenue Act of 1917 included in its definition of "invested capital"—

> (a) * * * (1) Actual cash paid in, (2) the actual cash value of tangible property paid in other than cash,

> for stock or shares in such corporation or partnership, at the time of such payment * * * and (3) paid in or earned surplus and undivided profits used or employed in the business, exclusive of undivided profits earned during the taxable year * * *. [Revenue Act of 1917, ch. 63, § 207, 40 Stat. 306.]

while Section 718, *supra,* did not include in its definition "undivided profits used or employed in the business." See Section 718, Revenue Code of 1939, *supra.* There is nothing in the language of Section 718 to indicate that Congress attempted to broaden the scope of the earlier act or to overturn or restrict the *LaBelle* decision. Therefore, we think that any discussion of the World War II Act must take account of *LaBelle* and conclude that it is applicable to World War II excess profits tax cases such as the case at bar.[6]

In the case at bar, the conversion of the bonds for the stock was nothing but a paper transaction that was carried out in accordance with the provisions of the convertible bonds. No new or additional capital was acquired by the taxpayer. While the *LaBelle* case did not involve convertible bonds, it illustrates that a taxpayer cannot increase its equity invested capital by the unrealized appreciation of its assets. Such capital can be increased only by the payment or transfer of new money or property to the taxpayer that can be properly considered working capital. This court said in *American Radiator & Standard Sanitary Corp.* v. *United States,* 155 Ct. Cl. 515, 521, 295 F. 2d 939, 942-943 (1961):

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[6] See *Brown Shoe Co.* v. *Commissioner,* 339 U.S. 583 (1950); *Reynolds Spring Co.* v. *Commissioner,* 181 F. 2d 638, 640 (C.A. 6th, 1950), *cert. denied,* 340 U.S. 821 (1950); *Gabriel Co.* v. *Commissioner,* 186 F. 2d 786, 794 (C.A. 6th, 1951), *cert. denied,* 341 U.S. 950 (1951); *Bard-Parker Co.* v. *Commissioner,* 218 F. 2d 52, 58 (C.A. 2d, 1954), *cert. denied,* 349 U.S. 906 (1955); *Western Maryland Railway Co.* v. *United States,* 227 F. 2d 576, 578 (C.A. 4th, 1955), *affirming* 131 F. Supp. 873, 897 (Md., 1955), *cert. denied,* 351 U.S. 907 (1956).

> Certainly, to be considered "property" for tax purposes, the rights received by a taxpayer must be of such vested character as to be properly considered *working capital.* [Emphasis supplied.]

The conversion of the bonds here added nothing to the working capital of the taxpayer.

The Tax Court has applied the principles of the *LaBelle* case in two World War II excess profits tax cases where it excluded from equity invested capital unrealized appreciation of assets where the taxpayers increased the value of the capital stock above the amount of money originally paid in for the stock.[7]

In 1919, the Bureau of Internal Revenue issued a ruling under Section 326 of the Revenue Act of 1918, c. 18, 40 Stat. 1057, which defined invested capital as follows:

> Section 326, Article 831: Meaning of invested capital.
>
> Where bonds are exchanged for stock in the same corporation under the terms of a convertible trust deed, it will be presumed, for the purpose of computing invested capital, that the value of the bonds is equivalent to the value of the stock. The addition to invested capital would accordingly be the amount for which the bonds were originally sold.[8]

This definition of invested capital is in accord with our view of this case and is applicable here even though this ruling was issued before the enactment of the World War II Excess Profits Tax statute. The addition to invested capital of the taxpayer was "the amount for which the bonds were originally sold."

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[7] See *Home Guaranty Abstract Co.* v. *Commissioner*, 8 T.C. 617, 621 (1947); and *L. A. Dreyfus Co.* v. *Commissioner*, decided October 31, 1949, 8 CCH Tax Ch. Mem. 972 (1949).

[8] O.D. 306, 1919 Cum. Bull. 283.

Revenue Ruling I.T. 2347, VI-1 Cum. Bull. 86 (1927) stated:

> When a corporation retires its bonds and converts them into stock, the issuing price of such stock, so far as the corporation is concerned, will be considered to be the issuing price of the bonds plus the amount of amortized discount previously taken as a deduction by the corporation.

See also G.C.M. 9674, X-2 Cum. Bull. 354 (1931) and T.D. 4603, XIV-2 Cum. Bull. 58 (1935), which are substantially to the same effect.

In the case of *Liquid Carbonic Corp.* v. *Commissioner,* 34 B.T.A. 1191, 1196 (1936), the Board of Tax Appeals held:

> * * * the conversion of bonds into capital stock of the obligor is purely a capital transaction; that is, a readjustment of the obligor's capital structure, which does not result in either a deductible loss or a taxable gain. The obligor does not pay out anything. It merely readjusts its capital. As we said in *375 Park Avenue Corporation, supra,* [23 B.T.A. 969], "Instead of suffering the outlay of money in excess of the amount borrowed, it created a new distribution of its shares, thus avoiding its fixed financial obligation and devoting the borrowed money to the ordinary risks of its business."

The taxpayer makes the further contention that if it cannot include in its equity invested capital the value of the stock or the value of the bonds at the time of the conversion, it should be allowed to include in such capital the cost basis of the last owners of the bonds who surrendered them for conversion. This argument is made on the theory that the bonds were property paid in for stock and is based

on the fact that some of the bonds changed hands many times between the time of their original issuance and the conversion and at much higher prices than were originally paid for them. This contention must fail because we are not concerned with the cost basis of the transferors, but only with the basis of the taxpayer. These bonds were debts of the taxpayer on which it had borrowed the amounts originally paid for the bonds. That was its basis and that is what was included in its equity invested capital. It matters not how many times the bonds changed hands nor how much the price increased for each sale of them prior to conversion, because none of the increased price was paid to taxpayer and consequently could not be included in its equity invested capital. Even if it could be said *arguendo* that the bonds were property paid in for stock at the time of conversion, all that could be included in plaintiff's equity invested capital under Section 718(a) and Section 113 of the 1939 Code was its cost or basis and not the cost or basis of the last transferor. The cost or basis of the plaintiff was the amount originally paid in for the bonds.

It is our view and we hold that all that was ever included in plaintiff's equity invested capital by the issuance of the convertible bonds and their conversion into taxpayer's stock was the money paid in for the bonds when they were originally issued.

Accordingly, plaintiff's motion for partial summary judgment as to Counts XXIX and XXX of its first amended petition is denied, and defendant's motion for partial summary judgment as to such counts of said petition is granted with the petition dismissed as to them. The case is remanded to the trial commissioner for further proceedings.

APPENDIX C

IN THE

UNITED STATES COURT OF CLAIMS

Nos. 142-67 and 95-68

(Decided November 13, 1970)

MISSOURI PACIFIC RAILROAD COMPANY

v.

THE UNITED STATES

ROBERT T. MOLLOY, attorney of record, for plaintiff.

E. ALAN MOORHOUSE, with whom was ASSISTANT ATTORNEY GENERAL JOHNNIE M. WALTERS, for defendant. PHILIP R. MILLER and THEODORE D. PEYSER, of counsel.

Before COWEN, *Chief Judge,* LARAMORE, DURFEE, DAVIS, COLLINS, SKELTON, and NICHOLS, *Judges.*

ON DEFENDANT'S MOTION FOR REHEARING OR RECONSIDERATION

PER CURIAM: Defendant has asked us to reconsider part of our holding in this case. 192 Ct. Cl. ——, 427 F. 2d 727 (June 12, 1970).[1] The objection is to the conclusion, in our original opinion, that, when new bonds are issued for old

[1] Plaintiff has also filed a motion for reconsideration which is being denied today, by order without opinion.

stocks, debt discount is available where the amount originally paid for the old stocks is less than the maturity value of the new debt securities for which they are exchanged. We applied that rule to the publicly held common stock of New Orleans, Texas & Mexico Railway Company, and remanded the case to the trial commissioner to determine the amount originally paid by the taxpayer-plaintiff for that stock. The Government urges that this rule is not appropriate for an exchange of new bonds for old stock.

Since our original opinion, a helpful decision has been rendered on this very point in the Southern District of New York. *Cities Service Co.* v. *United States,* 26 AFTR2d ¶70-5100, p. 70-5378 (July 24, 1970). Judge Mansfield there points out (26 AFTR2d at 70–5385) that the basic principle for the allowance of debt discount is that a "true loss", i.e., a detriment, must be sustained by a taxpayer issuing obligations payable at their face value at some future date, and that, if in fact the taxpayer receives a lesser consideration upon issuance than it will have to return at maturity, the difference is normally considered a debt discount in the absence of circumstances indicating otherwise. That is the general principle we followed in *Erie Lackawanna R.R.* v. *United States,* 190 Ct. Cl. 682, 422 F. 2d 425 (1970), and endeavored to apply in our opinion in the present case.

With respect to the particular problem of debt obligations exchanged for stock, the *Cities Service* opinion holds (26 AFTR2d at 70–5387) that the *minimum* amount the taxpayer may ascribe to the shares acquired by it for the new debt obligation is the original consideration, and "even if the market value of the shares at the time of the exchange had declined below their original issue price [taxpayer], would be precluded from claiming the decline in value as a loss because, having received the cost price upon issuance of the shares, it had not actually suffered a loss to the extent of the market decline." With this statement, we agree, of course.

The District Court then goes on to hold (26 AFTR2d at 70–5387), contrary to our original opinion in this case, that the original issue or cost price of the exchanged shares did not represent the ceiling value of the stock for the purpose of calculating debt discount. Its reasoning is that at the time of the exchange the shares could have a greater value to the taxpayer than the original issue or cost price. "Thus, where a taxpayer receives its own shares in exchange for issuance of its debentures, the value of 'what is received' for the purposes of determining the deductible loss or discount may be higher (though not lower) than the original issue price of the shares. The actual value to the taxpayer can be determined only after consideration of all relevant data, including the market value of the shares, the financial condition of the taxpayer at the time of the exchange, its profits prospects, and expert opinion."[2]

On reconsideration, persuaded by this *Cities Service* discussion, we hold that, with respect to shares of its own stock or stock in its subsidiaries, the present taxpayer cannot calculate, for debt discount purposes, the value of the stock at its cost or issuance price. That figure can be the floor but it cannot be the ceiling. The correct measure is the value of the New Orleans stock to plaintiff at the time of the exchange of the bonds for that stock.

In this instance, however, we need not order a trial to determine that value.[3] That determination has already been made. In taxpayer's reorganization proceedings, the value of the New Orleans stock was extensively canvassed before the Interstate Commerce Commission and the courts. See *Missouri Pac. R.R. Reorganization,* 275 I.C.C. 59, 113, 125-27 (1949); 290 I.C.C. 674, 678-9 (1954); *In re Missouri*

[2] The opinion emphasizes that the market price would be relevant but not conclusive, and that the significant figure is that "representing the value to plaintiff [the taxpayer] of the shares in question."

[3] In *Cities Service,* a trial was directed.

Pacific R.R., 93 F. Supp. 832, 848-49 (E.D. Mo., 1950), 129 F. Supp. 392, 399 (E.D. Mo. 1955); *State of Texas* v. *Group of Institutional Investors*, 191 F. 2d 265, 273-74 (8th Cir. 1951) *cert. denied*, 342 U.S. 904 (1952); *Missouri Pacific R.R. 5¼% S.S.B.C.* v. *Thompson*, 229 F. 2d 898, 900-01 (8th Cir. 1956). The final reorganization plan, which was confirmed and adopted, found the stock to be then worth $250 per share, but only $216 in maturity value of the bonds was allocated to each share, as the "equitable equivalent" of the $250 value. *Missouri Pac. R.R. Reorganization, supra*, 290 I.C.C. at 678-79. Thus, the value of the New Orleans stock, at the time of the exchange, has authoritatively been found, after considerable and careful inquiry (including expert testimony), to be not less than the maturity value of the bonds exchanged. *Cf. Arkansas-Missouri Power Corp.* v. *Paschal*, 243 F. 2d 584, 588 (8th Cir.), *cert denied*, 355 U.S. 835 (1957).

The fact that the stock was selling for less on the stock exchange is not at all conclusive (*Cities Service Co.* v. *United States, supra*, 26 AFTR2d at 70-5387), and in this case is clearly outweighed by the other factors which led the Interstate Commerce Commission and the federal court to find and determine that the new bonds were a "fair and equitable" equivalent for the New Orleans stock. There was, therefore, no debt discount on the issuance of the bonds since the plaintiff-taxpayer received at least the equivalent (in stock value) of the maturity value of the bonds.

This conclusion calls for a modification of our prior holding and opinion. The exchange involving the New Orleans stock falls into the same category as the majority of the transactions dealt with in that opinion—there was no debt discount on the transaction—and there is no need for a remand. The remand ordered in our prior opinion is, accordingly, restricted to the transaction involving the Little Rock bonds. In addition, the last portion of our

prior opinion, 192 Ct. Cl. ——, ——, 427 F. 2d at 732-34,[4] is modified to refer only to bonds and other debt obligations, not to stock, insofar as the holding is that the original value of the securities must be looked to for the purpose of determining whether a bond discount exists. The few references in that opinion to the original cost of shares of stock as determinative are stricken and replaced by the standard of the actual value of the stock to the taxpayer at the time of the exchange. It goes without saying that, with respect to bonds exchanged for bonds, the opinion still stands as written.

To the extent indicated in this opinion the defendant's motion for rehearing or reconsideration is granted and our prior decision and opinion are modified.

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[4] Beginning with the sentence (slip op., p. 8), "The same general rule applies, namely, that the true value of the stocks and bonds *in the eyes of the corporation* is the original value of the securities, which value becomes a part of the assets of the parent corporation as the result of the reorganization and merger," and continuing through to the end of the opinion.